

2. (a) Distinguish between cost push inflation and demand pull inflation. *[10 marks]*

Candidates may include the following information:

- definition of inflation
- explanation of cost push inflation, including an awareness of the different sources of cost increases like rising wage and salary rates, higher interest rates, higher profits, increased government taxes (like VAT), dearer imported inputs, rising prices of domestic raw materials
- explanation of demand pull inflation, including awareness of the different components of aggregate demand: consumption, investments, government expenditure and net exports
- use of AD/AS diagrams to illustrate cost push and demand pull inflation.

Candidates may refer to:

- role of expectations, business sentiment, the state of the economy and international conditions (like the occurring of an oil supply shock, for example)

Examiners should be aware that candidates may take a different approach, which if appropriate should be rewarded.

If a candidate only explains one cause of inflation they are restricted to level 2.

- (b) Evaluate the view that the consequences of inflation are more harmful to an economy than the consequences of unemployment. *[15 marks]*

Candidates may examine the consequences of unemployment, which may include:

- the economy not producing at its potential output, and so actual output is below potential output. Candidates may use a PPC to show this
- a misallocation of resources, which means the economy suffers from allocative inefficiency because consumer welfare is not being maximized
- the loss of potential tax revenue for the government because income tax revenue will fall as less people are working, and consumption-based tax revenue will fall as less goods and services are being purchased
- social costs can increase such as, arguably, crime rates, divorce, stress and suicide
- deterioration of human capital (de-skilling) occurs when people who have been unemployed for long periods of time lose skills and become demotivated
- less investment and a negative multiplier effect because businesses are likely to postpone or cancel plans to expand their productive capacity as they are worried about falling demand.

Candidates may examine the consequences of inflation, which may include:

- redistribution of income between different sectors of the economy, including between the poor and the wealthy who are able to protect themselves against the harmful effects of inflation
- discourages savings particularly if real interest rates are low or even negative
- misallocates resources away from productive assets as investors direct their finances towards speculative, non-productive assets
- affects fixed income earners because their real income or purchasing power falls as inflation rises and their nominal income stays the same
- encourages borrowing because future loan repayments will be in inflated currency
- reduces international competitiveness, particularly if the domestic inflation rate is higher than inflation rates overseas. This, in turn, could cause balance of payments problems
- creates investment uncertainty and so businesses are unlikely to commit themselves to capital projects.

Candidates may provide a reasoned evaluation on which is more harmful.

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Effective evaluation may be to:

- consider short run versus long run consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.